Journal of Asian Economics 23 (2012) 288–301

Contents lists available at ScienceDirect

Journal of Asian Economics

Foreign direct investment and innovation in China's e-commerce sector

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ARTICLE INFO

Article history:
Received 31 March 2010
Received in revised form 26 October 2010
Accepted 22 November 2010
Available online 5 December 2010

JEL classification:
L81
F21
O31

Keywords:
E-commerce
Foreign direct investment
Technology innovation

ABSTRACT

By comparing the business practices and performance of foreign-invested and local Internet companies in China, this article outlines the important factors that multinational corporations must address to gain competitive advantages in China's e-commerce sector. Specifically, this research compares EachNet (eBay) with Taobao in the consumer-to-consumer market; eLong (Expedia) with Ctrip and Joyo (Amazon) with Dangdang in the business-to-consumer market; and the online search engines Google China and Baidu. The author underscores the importance of local knowledge for firm performance and success. Foreign firms must improve their understanding of and ability to adapt to local cultural, social, economic, and political environments.

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1. Introduction

China has undergone vast economic reforms and encouraged foreign direct investment (FDI) in recent few decades. As a result, its economy has opened more to foreign businesses and investors, and FDI has risen. In 2007, China's inward FDI was estimated at $758 billion, ranking it sixth after the United States, United Kingdom, Germany, France, Germany, and Hong Kong (CIA, 2008). Approximately 490 of the world's 500 biggest companies have set up offices or acquired companies in China; more than 1160 global R&D centers have been established (First Financial Daily, 2008).

With the development of China's Internet infrastructure, new business models and technologies have been introduced to China, and major U.S. Internet companies have been directly investing its e-commerce market since the late 1990s. Among these entrants are industry leaders, such as the online auction site eBay, which acquired EachNet; Amazon, which acquired Joyo; Expedia, which owns a majority share of eLong; and Google, which built its own Web presence from the ground up. However, their performance in the respective e-commerce markets has lagged behind that of their local competitors by a large margin. Table 1 presents the background of these companies, as well as the local rivals they face and their performance in their respective markets.

Using these companies as exemplars, this study examines foreign firms' ability to transfer their technological leadership and market dominance to the Chinese market. The case studies of foreign-invested multinational companies (MNCs) in Chinese e-commerce markets allow for comparisons of their business practices with those of local companies, particularly with regard to their ability to employ their Web site (i.e., information technology) to engage and communicate with customers.

The research reveals that Chinese companies not only adopt and implement new technologies and business models developed by foreign firms but also do a better job innovating with the technology to cater to the local customers. To compete with their local rivals, U.S. companies thus require a better understanding of the macro environment, need to provide services

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doi:10.1016/j.asieco.2010.11.007

Table 1
Major players in China's e-commerce sector.

Market	U.S. companies and FDI mode	Chinese competitors and funding sources	Performance
Consumer-to-Consumer (C2C)	eBay.com: Founded in 1995 in San Jose, CA. Entered China in 2002 via a full acquisition of EachNet. Cumulative investment approximately $400 million to date.	Taobao.com: Founded in 2003 with an investment of RMB450 from Alibaba, a domestic company in the B2B market.	Since Taobao.com entered the market, eBay EachNet has suffered declining market shares, from more than 80% to 8.2% in five years. Taobao now claims 82% of the market.
		Paipai.com: Founded in 2006 by China's biggest Internet service portal, Tencent.	Paipai's market share was 9.9% as of July 2008.
Business-to-Consumer (B2C)	Amazon.com: Launched in Seattle, WA, in 1995. Joyo.com was founded in 2000 and acquired by Amazon in 2004 for $75 million.	Dangdang.com: Founded in 1999 in Beijing. Funded by domestic and foreign venture capital from Ke Wen, American Tiger Fund, IDG, and Softbank.	Dangdang.com is the leader in the B2C market, with 35% of the market share. Joyo Amazon's market share is 29%.
Online Travel	eLong.com: Founded in 1999 in Delaware. Expedia.com bought 52% of it shares in 2007.	Ctrip.com: Founded in Shanghai in 1999. Went public on NASDAQ in 2003.	In the first quarter of 2008, Ctrip earned revenue of $52.29 million and net income of $14.1 million. In the same period, eLong's revenue and net income were $11.62 million and −$4.65 million.
Online Search	Google.com: Founded in Mountain View, CA, in 1998. Entered China by setting up its own local domain, google.cn, in 2006.	Baidu.com: Founded in Beijing 2000. Went public on NASDAQ in 2005.	As of 2007, Baidu commands the top position in China's online search market, with a 55% market share. Google has 21%.

tailored to the local customers, and must resolve potential conflicts within their organizations that arise from their acquisitions. Even more important, they need to rethink and modify strategies that may have worked in the United States and learn from their Chinese competitors how to maintain a foothold in that unique market. This study therefore outlines in detail the practical insights and recommendations for both MNCs and domestic companies derived from the case studies.

The rest of this article is organized as follows: Section 2 contains a review of related literature and some relevant hypotheses for testing. Section 3 provides an overview of China's Internet market and discusses the specific conditions that mark the e-commerce industry, consumers, and major players in the market. Section 4 presents the case studies as a means to contrast some U.S. multinationals with their local rivals in several markets, according to their entry strategy, investment decisions, marketing practices, and competition outcomes. The conclusion in Section 5 offers a discussion of the major implications of these case studies and recommendations for both MNCs and domestic companies.

2. Theory and hypotheses development

Previous literature has examined the effects of market characteristics, country risks, and culture distances on FDI. It suggests a positive relationship between Internet development and FDI (Choi, 2003). In addition, Ko (2007) finds significant impacts of network externalities of Internet usage: positive (negative) network externality encourages (discourages) inward FDI. Furthermore, a positive network externality is more effective in reducing the effect of distance barriers between investing and hosting countries on FDI. Rothaermel, Kotha, and Kevin Steensma (2006) study roughly 7000 market entry decisions (using country-specific investments) made by 179 U.S Internet companies and find that beyond country risk, culture plays an important role. Specifically, uncertainty avoidance decreases the chance of international market entry, but individualism increases it. In addition, market size moderates these relationships by strengthening the positive effects while attenuating the negative ones. Thus,

H_1 FDI and Market Entry: FDI from the United States to China increases due to China's growing openness to foreign businesses and investment, positive network externalities, low uncertainty avoidance culture, and attractive the market size.

Managers, especially of MNCs, must determine when to enter a foreign market, how competitive their businesses will be in that market, and what factors might influence their chances of success. For a MNC, being a pioneer or first-mover in an emerging market can have many advantages (e.g. Ramamurti, 2000). In analyzing a large data set of foreign investors in China, Cui and Lui (2005) identify significant, albeit small, first-mover advantages in market share. However, firm size, industry growth, and local competition likely moderate this first-mover advantage. Using data from 168 foreign firms that invested in China and India, Johnson and Tellis (2008) also find empirically that firms that entered these emerging markets earlier were more likely to succeed. Smaller economic distance, lower risks, and increased openness of the host economy should significantly increase the success rate of foreign firms, whereas local competition reduces it.

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